

REDRESSING THE IMBALANCE OF REGULATORY CAPTURE

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Mr. President, one of my primary concerns in the debate on Wall Street reform has been that we should not write legislation that turns all of the major reform proposals over to the regulators. That instead we should follow in the footsteps of our forebears from the 1930s, those Senators of old who made the tough decisions and wrote bright line laws which lasted for over 60 years – until they were repealed.

I also argued we should not depend on regulators who had not used powers they already possessed. Instead, we passed a Senate bill that in the area of bank regulation primarily restates existing regulatory powers, provides some general directional authority, and leaves us with the hope that our present regulators will devise and enforce rules that prevent another financial crisis. That a systemic risk council of regulators will be able to detect early warning signals of impending financial instability. That the regulators will impose higher capital standards on systemically significant banks. That the regulators will be able to resolve failing institutions. And so on.

Yesterday, a third reason for writing laws and not turning to regulators was brought home to me. It relates to how the Securities and Exchange Commission is studying the incredible unregulated growth of high frequency trading. I am deeply concerned by preliminary reports of the make-up of SEC panels studying high frequency trading after the “flash crash” of May 6. On that day, the Dow Jones fell almost 1000 points, temporarily causing a \$1 trillion drop in market value.

I call on the SEC to make those panels more balanced by adding individuals from outside of Wall Street who are truly sincere and knowledgeable about the further actions the SEC may need to take.

In just a few years time, high frequency trading has grown from just 30 percent to 70 percent of the daily trading volume of stocks. These black box computers trade thousands of shares per second across more than 50 market centers with no real transparency and therefore no effective regulation. If those ingredients – no transparency, no regulation – sound familiar, it might be because those same characteristics applied to over-the-counter derivatives.

My concern about the opaque and unregulated nature of high frequency trading led me to write to SEC Chairman Mary Schapiro in August 2009 calling for a comprehensive review of market structure issues. I wrote that: “The current market structure appears to be the consequence of regulatory structures designed to increase efficiency and thereby provide the greatest benefits to the highest volume traders. The implications of the current system for buy-and-hold investors have not been the subject of a thorough analysis. I believe the SEC’s rules have effectively placed ‘increased liquidity’ as a value above fair execution of trades for all investors.”

On September 10, Chairman Shapiro responded, saying she recognized the importance of standing up for the interests of long-term investors and would undertake a comprehensive review of market structure issues.

Because I had heard these concerns raised by credible voices, in a speech on September 14, 2009, I predicted some of the events of last May 6. At that time, I said: “[U]nlike specialists and traditional market-makers that are regulated, some of these new high-frequency traders are unregulated, though they are acting in a market-maker capacity. . . . If we experience another shock to the financial system, will this new, and dominant, type of pseudo market maker act in the interest of the markets when we really need them? ... Will they step up and maintain a two-sided market, or will they simply shut off the machines and walk away? Even worse, will they seek even further profit and exacerbate the downside?”

On October 28, Senator Jack Reed convened a hearing of the Securities Subcommittee on these issues. He graciously asked me to testify at the hearing, where I said in my statement: “First, we must avoid systemic risk to the markets. Our recent history teaches us that when markets develop too rapidly, when they are not transparent, effectively regulated or fair – a breakdown can trigger a disaster.”

On November 20, I sent a letter to Chairman Schapiro summarizing some of the hearing testimony and called on the Commission to act quickly to “tag” high frequency traders and address the systemic risks they pose.

On December 3, Chairman Schapiro responded to my letter and wrote that the SEC would issue a concept release in January and put forth two rule proposals that would, respectively, impose tagging and disclosure requirements on high frequency traders and address the risk of naked access arrangements.

In January, the SEC did indeed issue a concept release, as well as a proposed rule banning naked access arrangements. Unfortunately, it was months later – April 14 – before the SEC finally issued the “large trader” rule requiring tagging of high frequency traders. In that proposed rule, the SEC noted that the current data collection system is inadequate to recreate market events and unusual trading activity.

Then, on May 6, the disaster struck that I and others had been worried about. For 20 minutes, our stock market did not perform its central function: discovering prices by balancing buyers and sellers. And as the SEC has noted – both before and after the “flash crash” – it indeed does not have the data to discover easily the causes of the market meltdown.

It is true that the SEC and CFTC have gone into overdrive since May 6. Indeed, the staffs and commissioners of both agencies have worked heroically and round the clock to try to recreate and study the unusual trading activity of that day. They have kicked into high gear and formed an advisory commission. They have quickly come together to propose two more possible rules: an industry wide circuit breaker, so that if we ever again have another market “flash crash” we won’t see absurd prices for some of our nation’s proudest company’s stock. And also a long overdue proposal to have a consolidated audit trail across market centers that will finally provide

regulators with access to the information they need to police manipulation, understand trading practices and reconstruct unusual market activity in a timely manner.

After weeks of helpful action by the SEC – when the industry itself was helping the agencies to find band-aid solutions – now is not the time to see the SEC continue with rule-making by Wall Street-consensus.

We may need further action, probably against the interests of those who benefit from the current market design. Further action only through Wall Street-consensus is a prescription for no change.

This all brings me to why I became so concerned yesterday. As part of the Commission's ongoing market structure review, the SEC has decided to hold a Roundtable discussion on June 2nd. I have learned preliminary reports about the make-up of one of the panels.

Based on those reports, the panel is dramatically out of balance. It appears as though it was chosen primarily to hear testimony that reinforces the top-line defenses of the current market structure – that high frequency trading provides liquidity and reduces spreads – rather than a deep dive into the problems that caused severe market dislocation on May 6 and damaged our market's credibility.

I have called on the SEC to add more participants to give the panels some semblance of balance. Frankly, Mr. President, I find the preliminary reports to be so stacked in favor of the entrenched money that has caused the very problems we seek to address that the panel itself stands as a symbolic failure of the regulators and regulatory system – that is, with the exception of a few brave souls who have been invited to critique the conventional industry wisdom.

Let me read from the comment letters and statements of five of the expected participants. Not surprisingly, in comments to the SEC and members of the industry, most of which were made prior to the unusual volatility of May 6, each of these five participants reported that – contrary to the concerns I and others had expressed – they think the markets are running as smoothly as ever.

One of the expected panelists wrote: “[O]ver the past 18 months – since the height of the financial crisis – the Commission has been very active with rule making proposals. Nearly all of the issues that may have contributed to diminishing investor confidence have been addressed by Commission rule-making.”

That panelist also wrote: “We believe that the current national market system is performing extremely well. For instance, the performance during the 2008 financial crisis suggests that our equity markets are resilient and robust even during times of stress and dislocation.”

Another expected participant wrote in an email sent widely that his exchange “doesn’t believe the equities markets are broken. To the contrary, we would argue that the US equity markets were a shining model of reliability and healthy function during what some are calling one of the most challenging and difficult times in recent market history.”

Another expected participant wrote: “Implementing any type of regulation that would limit the tools or the effectiveness of automation available for use by any class of investor in the name of ‘fairness’ would turn back the clock on the U S Equity market and undo years of innovation and investment.”

That’s an interesting comment, Mr. President, because I have always believed that fairness was the hallmark and number one priority of US markets.

Another expected panelist sounded a similar note in a comment letter filed before May 6: “All market regulation should be evaluated with respect to its impact on the liquidity and efficiency of equity markets for the benefit of investors... For example, certain short-term traders and high frequency traders provide liquidity to the markets. Although some of these short-term traders may differ at times in their goals and overall position vis-a-vis other types of investors, we believe, on the whole, that the liquidity they provide is beneficial to the markets.”

Mr. President, I agree with that statement. Liquidity is vital to the strength and stability of our markets. But on May 6, liquidity vanished, as some of the short-term traders left the marketplace. And for those who didn’t, we learned that the liquidity they provide was about 1/100th of an inch deep.

Finally, another panelist co-signed a letter stating: “We believe that any assessment of the current market structure or the impacts of ‘high frequency trading’ should begin with the recognition that by virtually all measures, the quality of the markets has never been better... The equity markets have also proven to be remarkably resilient. Despite the significant stresses that occurred during the recent financial crisis, U.S. equity markets remained open, liquid and efficient every day, while other less competitive and less transparent markets failed.”

The SEC has picked one voice for the panel – Sal Arnuk of Themis Trading – who has been a vocal and intelligent critic of high frequency trading. He has valiantly raised questions about market structure and the trading advantages that high frequency traders enjoy, but he is being asked to go up against six Wall Street insiders who will no doubt be primed to argue against his position.

People wonder why Americans have such little faith in Washington, DC. Talk about a stacked deck.

Mr. President, I’m particularly concerned by the upcoming SEC roundtable on high frequency trading because it is reminiscent of the one that the SEC held last September on “naked” short selling. Naked short selling occurs when a trader sells a financial instrument short without first borrowing it or even ensuring it can be borrowed.

After the SEC’s repeal of the 70-year uptick rule in 2007, abusive short-selling facilitated the sort of self-fulfilling bear raids on stocks that we saw during the financial crisis. Since coming to office last year, I have highlighted this serious problem through a series of speeches and letters to the SEC. Along with seven other senators, I also called for pre-borrow requirements and centralized “hard locate” system solutions.

In response to those concerns, the SEC held a roundtable last September to examine these proposals. Unfortunately, the panel was stacked with industry representatives even though the industry had done virtually nothing to address what had become a glaring problem. Goldman Sachs, State Street, and the Depository Trust & Clearing Corporation (DTCC), among others, participated. Not surprisingly, these panelists were resistant to the hard-locate requirement and other serious solutions, even while they generally acknowledged that there are bad actors who engage in naked short selling and don't comply with the current locate system. DTCC even backed away from discussing the very proposal it had laid before the U.S. Senate.

I fear that an industry-stacked panel in the upcoming roundtable on high frequency trading will be more of the same and will once again dismiss fundamental reforms, ultimately leaving retail and long-term investors with half-measures or none at all.

Why? Because repeatedly we see that regulators are dependent almost exclusively for the information and evidence they receive about market problems on the very market participants they are supposed to be confronting about needed changes.

This is as true in other agencies – like the agency charged with the oversight of oil drilling – as it is at the SEC.

The regulators are surrounded – indeed they consciously choose to surround themselves – by an echo chamber of industry players who are making literally billions of dollars under the current system.

Who speaks to the regulators on behalf of the average investor?

Who outside of the industry itself has access to the data that only the industry controls?

Who other than the market players who have invested so much of their capital into the very systems that profit and serve their own interests has the analytical capability to lead the SEC in a different direction?

We must have evidenced-based rules in our system, we are told.

But when all the evidence comes from Wall Street, who is going to stop Wall Street from once again pulling the wool over the SEC's eyes?

The events of May 6 demonstrate that technological developments have outpaced regulatory understanding. If we are to ensure our markets are safe from future failures – because the markets did fail their primary function on May 6th - regulators must catch up immediately.

Competition is critical in our markets and has led to many positive developments. But with competition, we also need good regulation. We need referees on the field who will blow their whistles when the game becomes rigged. In football, we don't let the players make up the rules during the game.

So, Mr. President, we need action from our regulators, not negotiation. We need independent leadership by the SEC, not management by consensus with Wall Street.

Again, I call on the SEC to rebalance these panels. The Commission will never be able to catch up, Mr. President, if it hears mostly from those who will fight to maintain the status quo.

The SEC must hear from those who speak for long-term investors and others who use our capital markets, not just from those who profit from high frequency trading.

The American people deserve no less.

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